

Letter of Findings: 04-20140408
Gross Retail Tax
For the Years 2011 and 2012

NOTICE: IC § 6-8.1-3-3.5 and IC § 4-22-7-7 require the publication of this document in the Indiana Register. This document provides the general public with information about the Department's official position concerning a specific set of facts and issues. This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.

ISSUE

I. Gross Retail Tax - Equipment Used in Direct Production.

Authority: IC § 6-2.5-2-1(a); IC § 6-2.5-2-1(b); IC § 6-2.5-3-1(a); IC § 6-2.5-3-2(a); IC § 6-8.1-5-1(c); IC § 6-2.5-5-3; IC § 6-2.5-5-3(b); *Wendt LLP v. Indiana Dep't of State Revenue*, 977 N.E.2d 480 (Ind. Tax Ct. 2012); *Indiana Dep't of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463 (Ind. 2012); *Scopelite v. Indiana Dep't of Local Gov't Fin.*, 939 N.E.2d 1138 (Ind. Tax Ct. 2010); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289 (Ind. Tax Ct. 2007); *Rhoads v. Ind. Dep't of State Revenue*, 774 N.E.2d 1044 (Ind. Tax Ct. 2002); [45 IAC 2.2-5-8](#); [45 IAC 2.2-5-8\(a\)](#); [45 IAC 2.2-5-8\(c\)](#); [45 IAC 2.2-5-8\(d\)](#); [45 IAC 2.2-5-8\(g\)](#); [45 IAC 2.2-5-8\(k\)](#).

Taxpayer argues that certain equipment it purchased is exempt from sales/use tax because the equipment is directly used in the direct production of Taxpayer's corrugated containers.

STATEMENT OF FACTS

Taxpayer is an Indiana company in the business of designing and manufacturing corrugated cardboard containers and cartons. Taxpayer sells its products to wholesalers, retailers, and other manufacturers.

The Indiana Department of Revenue ("Department") conducted an audit review of Taxpayer's business records and tax returns. The audit resulted in an assessment of additional sales/use tax. Taxpayer disagreed with a portion of the assessment and submitted a protest to that effect. An administrative hearing was conducted during which Taxpayer's representative explained the basis for the protest. This Letter of Findings results.

I. Gross Retail Tax - Equipment Used in Direct Production.

DISCUSSION

Taxpayer manufactures cardboard boxes to individual customer specifications. The Department reviewed Taxpayer's production process and found that three items of conveyor equipment were not directly involved in the production of the boxes. The audit concluded taxpayer should have paid sales tax on the purchase of a conveyor, "used power conveyor," and "conveyor equipment."

The audit described Taxpayer's production of custom-designed cardboard boxes as follows:

The [T]axpayer operates four converting press machines. One machine is capable of converting small boxes into customer's specifications. The second machine is capable of converting medium size boxes, the third machine converts large size boxes and the fourth machine converts jumbo size boxes into customer's specifications.

Taxpayer starts the production process by transporting cardboard sheets from its receiving dock by forklift and conveyor belt to a "converting press machine." Once the cardboard sheets are inserted into the machine, "the conversion occurs." The audit found that the "converting press machines" were where the actual "manufacturing" occurred. The "converting press machines" change the original cardboard sheets into marketable boxes altered to customer specifications. As explained in the audit report:

Once the flat boxes are changed into the required specification, the fully converted product now exits the converting machine (this is where manufacturing ends) and right after exiting the converting machine; the flat boxes are tied and bundled into medium size batch[es]. The bundles of boxes are then moved by another

rolling conveyor (attached to the end of the converting machine) to the unitization/palletization where the bundles are bound together in many bundles with large straps to be taken to either the warehouse or shipping.

The audit description contains an inaccuracy. Taxpayer does not insert small, large, or jumbo size boxes into the machines. Taxpayer inserts unformed cardboard sheets into the "converting press machines" which manufactures boxes which are sized and cut to the customer's specifications.

Taxpayer disagrees with the audit's characterization of its production process and explains as follows:

When the pieces of cardboard exit the machine they are not in completed form. They are pieces of cut cardboard that are stacked on top of one another. Once they are stacked the pieces are moved to the "unitization" machine that binds them together. It is between the two machines (cutting machine and unitization machine) that we find the . . . conveyors. Before this particular machine attaches the cardboard pieces together they are single sheets of cardboard that are not [] sold to a customer in that form. This would be the same thing as purchasing one M&M at a time, instead of the entire package.

A. Burden of Proof.

As a threshold issue, it is the Taxpayer's responsibility to establish that the existing tax assessment is incorrect. As stated in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." *Indiana Dep't of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463, 466 (Ind. 2012); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007). Thus, a taxpayer is required to provide documentation explaining and supporting his or her challenge that the Department's position is wrong. Poorly developed and non-cogent arguments are subject to waiver. *Scopelite v. Indiana Dep't of Local Gov't Fin.*, 939 N.E.2d 1138, 1145 (Ind. Tax Ct. 2010); *Wendt LLP v. Indiana Dep't of State Revenue*, 977 N.E.2d 480, 486 n.9 (Ind. Tax Ct. 2012).

B. Indiana Sales and Use Tax.

Indiana imposes an excise tax called "the state gross retail tax" (or "sales tax") on retail transactions made in Indiana. IC § 6-2.5-2-1(a). A person who acquires property in a retail transaction (a "retail purchaser") is liable for the sales tax on the transaction. IC § 6-2.5-2-1(b).

Indiana also imposes a complementary excise tax called "the use tax" on "the storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction, regardless of the location of that transaction or of the retail merchant making that transaction." IC § 6-2.5-3-2(a). Use means the "exercise of any right or power of ownership over tangible personal property." IC § 6-2.5-3-1(a).

In effect and practice, the use tax is functionally equivalent to the sales tax. See *Rhoades v. Ind. Dep't of State Revenue*, 774 N.E.2d 1044, 1047 (Ind. Tax Ct. 2002).

Taxpayer is in the business of manufacturing cardboard containers. The general rule is that all purchases of tangible personal property by persons engaged in the direct production, manufacture, fabrication, assembly or finishing of tangible personal property - such as cardboard containers - are taxable. [45 IAC 2.2-5-8\(a\)](#).

C. Manufacturing Exemption.

As authority for its conclusion that its three items of conveyor equipment are exempt, Taxpayer relies IC § 6-2.5-5-3, which states in part:

(b) Except as provided in subsection (c), transactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property.

(c) The exemption provided in subsection (b) does not apply to transactions involving distribution equipment or transmission equipment acquired by a public utility engaged in generating electricity.

The Department's regulation, [45 IAC 2.2-5-8](#), explains that a taxpayer is entitled to purchase machinery, tools, and equipment without payment of the gross retail tax when the equipment is used in the direct production of

tangible personal property. [45 IAC 2.2-5-8\(a\)](#) emphasizes that the exemption is limited to that equipment "directly used by the purchaser in direct production." [45 IAC 2.2-5-8\(c\)](#) specifies that "directly used" means that the equipment has "an immediate effect on the article being produced." Refining the definition further, the regulation states that "[p]roperty has an immediate effect on the article being produced if it is an essential and integral part of an integrated process which produces tangible personal property." *Id.* See IC § 6-2.5-5-3(b). However, it should also be noted that "[t]he fact particular property may be considered essential to the conduct of the business of manufacturing because its use is required . . . by practical necessity does not mean itself that the property 'has an immediate effect upon the article being produced.'" [45 IAC 2.2-5-8\(g\)](#).

Proper application of this particular exemption requires determining at what point "production" begins and at what point "production" ends. [45 IAC 2.2-5-8\(d\)](#) states:

Pre-production and post-production activities. "Direct use in the production process" begins at the point of the first operation or activity constituting part of the integrated production process and ends at the point that the production has altered the item to its completed form, including packaging, if required.

In addition, [45 IAC 2.2-5-8\(c\)](#) requires that exempt equipment must have an immediate effect on the product being produced:

The state gross retail tax does not apply to purchases of manufacturing machinery, tools, and equipment to be directly used by the purchaser in the production process provided that such machinery, tools, and equipment are directly used in the production process; i.e., they have an immediate effect on the article being produced. Property has an immediate effect on the article being produced if it is an essential and integral part of an integrated process which produces tangible personal property.

Finally, [45 IAC 2.2-5-8\(k\)](#) specifies that, in order to qualify for the exemption, the articles being produced have undergone a "substantial change."

"Direct production, manufacture, fabrication, assembly, or finishing of tangible personal property" is performance as a business of an integrated series of operations which places tangible personal property in a form, composition, or character different from that in which it was acquired. The change in form, composition, or character must be a substantial change, and it must result in a transformation of property into a different product having a distinctive name, character, and use. Operations such as compounding, fabricating, or assembling are illustrative of the types of operations which may qualify under this definition.

To summarize, machinery, tools, and equipment purchased for use in the production of goods are subject to use tax unless the property used has a direct and immediate effect on the goods produced and is essential to an integrated process used to produce those marketable goods.

The issue is whether the specific conveyors and conveyor equipment are exempt on the ground that these items of equipment are "directly used by the purchaser in the production process [because] they have an immediate effect on the article being produced." [45 IAC 2.2-5-8\(c\)](#).

D. Analysis.

The Department is unable to agree that the conveyors are exempt from sales tax because manufacture of Taxpayer's product is completed after leaving the converting press machine. The conveyors and unitization/palletizer machine do not have an immediate effect on the finished product; the conveyors do not change the form, composition, or character of Taxpayer's finished product. The conveyors may be a necessary component of Taxpayer's overall process but, as specified in [45 IAC 2.2-5-8\(g\)](#), the fact that a particular item is necessary does not mean itself that the item has an immediate effect on Taxpayer's cardboard containers.

The conveyors are necessary devices but are non-exempt post-production equipment.

FINDING

Taxpayer's protest is respectfully denied.

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